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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 97-0078 RST
Sales/Use Tax — Industrial Exemptions
Sales/Use Tax — Environmental Control Equipment
Sales/Use Tax — Preparation Plant Equipment
Sales/Use Tax — Rolling Stock
Tax Administration — Negligence Penalty
For Tax Periods: 1992, 1993, And 1994

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ISSUES

I. Sales/Use Tax — Industrial Exemptions

Authority: IC 6-2.5-5-3;
45 IAC 2.2-5-9;
Indiana Department of State Revenue v. Cave Stone, Inc. (1983), 457 N.E.2d 520;
General Motors Corporation v. Department of State Revenue, (Ind.Tax 1991) 578 N.E.2d 399

Taxpayer protests the assessment of Indiana use tax on its purchase of manufacturing machinery, tools, and equipment used in the mining of coal.

II. Sales/Use Tax — Environmental Control Equipment

Authority: IC 6-2.5-5-30; IC 14-34-1 *et. seq*.; IC 14-36-1-1
45 IAC 2.2-5-70;
Surface Mining Control and Reclamation Act, 30 U.S.C. § 1201 *et. seq.*

Taxpayer protests the assessment of Indiana use tax on purchases of tangible personal property made to comply with environmental standards and regulations.

III. Sales/Use Tax — Preparation Plant Equipment

Authority: IC 6-2.5-5-30
45 IAC 2.2-5-9; 45 IAC 2.2-5-70

Taxpayer protests the assessment of Indiana use tax on its purchase of tangible personal property related to the operation of its preparation plant.

IV. Sales/Use Tax — Rolling Stock

Authority: IC 6-2.5-5-27.5
P.L.61-1997

Taxpayer protests the assessment of use tax on its rail transportation equipment, related parts, and related supplies.

V. Tax Administration — Negligence Penalty

Authority: IC 6-8.1-10-2.1
45 IAC 15-11-2

Taxpayer protests the imposition of a ten-percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer's principal business activity involves the mining and selling of coal. In its business, taxpayer works one underground and several surface mines. These mines are located in Indiana and Illinois. Additionally, to facilitate the shipment of coal to its customers, taxpayer operates rail and barge loadout facilities.

During audit, it was discovered that taxpayer had failed to pay sales tax, or self-assess use tax, on certain items associated with the operation of its rail and barge loadout facilities. Audit also assessed use tax on equipment associated with taxpayer's waste disposal and land reclamation projects. Taxpayer, for reasons that follow, disagrees with these assessments.

I. Sales/Use Tax — Industrial Exemptions

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchase of machinery, tools, and equipment used in the mining of coal.

Taxpayer mines coal from different locations. After the coal is mined, it is taken to a preparation ("wash" or "prep") plant where it is cleaned. The coal is then segregated by grade into stockpiles. Each stockpile has its own compositional makeup – as measured by ash fusion, temperature, hardness, heat content, moisture, sulfur content, BTU content, and size. This compositional makeup does not remain static. Taxpayer manipulates the characteristics of each stockpile by adding coal from other stockpiles.

Taxpayer's customers burn coal. Because of air quality standards tied to BTU and sulfur emission levels, taxpayer's customers require coal that, when burned, meets these specific emission standards. In order to supply the right mix of coal to its customers, taxpayer manipulates the composite characteristics of each stockpile prior to shipment. Taxpayer calls this manipulation "blending".

"Blending", for taxpayer, refers to any activity that results in the combination of different grades of coal. According to taxpayer, blending activities occur throughout its entire production process. Blending occurs when taxpayer combines, after cleaning, coal from one stockpile with coal from another. Blending occurs when taxpayer transfers coal from aboveground stockpiles to underground hoppers. And blending occurs when taxpayer loads coal from different stockpiles into trucks, and barges, and railway cars. As described, "blending" is a continuous, systematic, and integrated part of taxpayer's production process. To engage in these "blending" activities, taxpayer has purchased a variety of equipment and repair parts. Taxpayer paid neither sales nor use tax on these items.

In Indiana, an excise tax (sales tax) is imposed on retail transactions. A complementary excise tax (use tax) is imposed on tangible personal property stored, used, or consumed in this state. Several exemptions from these taxes are available. Taxpayer, in this instance, invokes one of the industrial exemptions.

Referred to as the equipment exemption, IC 6-2.5-5-3(b) reads:

> Transactions involving manufacturing machinery, tools and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct* use in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. (Emphasis added.)

In *Indiana Department of State Revenue v. Cave Stone, Inc*. (1983), 457 N.E. 2d 520, the Supreme Court of Indiana interpreted the "double direct" language of IC 6-2.5-5-3(b) to require the equipment used be an essential and integral part of the production process. However, in order to qualify for this exemption, taxpayer must first show that the equipment in question was used in an activity within its production process. Because, as taxpayer is aware, items used in pre-production and post-production activities do not qualify for exempt treatment. (See 45 IAC 2.2-5-9.)

Taxpayer notes that its production process is not complete until its most marketable product - blended coal - has been produced. (See *General Motors Corporation v. Department of State Revenue,* (Ind.Tax 1991) 578 N.E.2d 399.) Consistent with the holding in *General Motors*, taxpayer defines its production process as incorporating every activity that results in the blending of coal. Since taxpayer "blends" as it loads coal onto barges, and trucks, and railway cars, taxpayer reasons that loading must also be an exempt activity. From this, it necessarily follows that all activities occurring prior to the shipment of coal from loadout facilities are properly characterized as part of taxpayer's production process. This expansive definition of taxpayer's production process would also serve to exempt taxpayer's transport of coal, as work-in-process, from taxpayer's mining facilities and prep plants to taxpayer's loadout facilities.

As further support for its exemption argument, taxpayer notes that "blending" operations fit comfortably within the exemption language of 45 IAC 2.2-5-9. Specifically, taxpayer directs the Department's attention to 45 IAC 2.2-5-9(c)(4), which provides in part:

> The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment may not touch the work-in-process or, by itself, cause a change in the product is not determinative.
>
> (F) Equipment used to blend different grades of coal together so that the final product meets customer specifications regarding quality and sulfur content.

Taxpayer summarizes its position by stating that the aforementioned statutory and regulatory language, as well as the relevant court cases, all support utilization of the industrial exemptions for blending operations.

The Department, however, finds taxpayer's transportation of coal to loadout facilities and the subsequent loading of coal onto barges and railway cars, are properly characterized as a function of shipping, and not production. As such, they are non-exempt post-production activities.

In reaching this conclusion, the Department is guided by language found in 45 IAC 2.2-5-9. Subsection (g) states the general proposition that *"[t]ransportation equipment* used in mining or extraction is taxable unless it is directly used in the mining or extraction process." Example (3) of subsection (g) illustrates a particularly salient non-exempt activity: "*[f]ront-end loaders, cranes, and equipment used to load coal onto trucks, railroad cars, or barges for delivery to customers are taxable*." Subsection (e)(1) gives examples of *taxable* machinery, tools, and equipment used in mining and extraction operations - including "*equipment used to load extracted and processed minerals from storage stockpiles to railroad cars.*" Additionally, subsection (j) states *shipping and loading of minerals are non-operational activities*; as such, machinery, tools, and equipment used in these activities are subject to tax. (Emphasis added.)

Taxpayer's conceptualization of blending is overbroad; blending is neither a subset of nor synonymous with loading. The language of 45 IAC 2.2-5-9 describes two mutually exclusive

activities. To accept taxpayer's definition - that blending and loading can be concomitant activities - would nullify the language of 45 IAC 2.2-5-9(g) example 3, as well as subsection (e)(1), and subsection (j). As explicit as the language of 2.2-5-9(c)(4) *exempting* equipment used in blending operations, so to is the language authorizing taxation of equipment used in loading and shipping activities.

FINDINGS

The Department finds the loading and transport of coal from mines and prep plants to loadout facilities, as well as the loading of coal onto rail cars and barges at loadout facilities, are functions associated with shipping - a taxable post-production activity. Consequently, items used in these activities do not qualify for any of the industrial exemptions. Taxpayer's protest is denied.

II. Sales/Use Tax — Environmental Control Equipment

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchase of tangible personal property made to comply with environmental regulations.

Taxpayer's mining operations – both surface and underground - create a considerable amount of coarse and slurry waste (refuse). Taxpayer moves this refuse to a disposal site (slurry pond). At the pond, this refuse is dumped and layered to allow retained moisture to drain. Eventually, the site is covered with topsoil and cultivated as farmland. Taxpayer has purchased a variety of equipment - including bulldozers and trucks - to transport and maintain this refuse, as well as to assist in land reclamation.

Audit determined that taxpayer's bulldozers, trucks, and other equipment used in transporting waste and assisting in land reclamation, were not exempt from Indiana sales and use taxes. Audit based its denial on two reasons. First, since taxpayer's vehicles "were being used to haul and handle waste materials outside the mining process," Audit felt these items could not qualify for any of the industrial exemptions. And second, Audit reasoned taxpayer could not be eligible for the environmental quality compliance exemption (see IC 6-2.5-5-30) because taxpayer's vehicles and equipment were used exclusively for handling waste products, rather than used predominantly in activities required to meet environmental regulations and standards.

Indiana has statutory (IC 6-2.5-5-30) and regulatory (45 IAC 2.2-5-70) language exempting from Indiana sales tax tangible personal property used to comply with environmental quality statutes, regulations, or standards.

IC 6-2.5-5-30 provides:

> Sales of tangible personal property are exempt from the state gross retail tax if:

(1) the property constitutes, is incorporated into, or is consumed in the operation of, a device, facility, or structure predominantly used and acquired for the purpose of complying with any state, local, or federal environmental quality statutes, regulations, or standards; and

(2) the person acquiring the property is engaged in the business of manufacturing, processing, refining, mining, or agriculture.

Taxpayer argues that since its trucks, refuse equipment, and other related tangible personal property are used in a manner consistent with the required elements of IC 6-2.5-5-30, taxpayer should be able to invoke the environmental control equipment exemption.

Taxpayer cites *Indiana Department of Environmental Management v. Amax, Inc.*, 529 N.E.2d 1209, for the proposition that equipment - specifically, tractors, bulldozers, and gob haulers - used predominantly to satisfy land reclamation requirements imposed by federal and state laws are properly characterized as environmental control facilities.

In *Amax*, a property tax case, the court interpreted the scope of IC 6-1.1-10-9. This statute exempted "industrial waste control facilities" from property taxation. In holding for Amax, the court found that Amax's activities, which involved the reclamation of land used in surface mining operations, were primarily for the prevention or control of pollution. Consequently, the equipment at issue qualified for the exemption as "industrial waste control facilities" under IC 6-1.1-10-9.

Taxpayer, via analogy, makes a similar argument. Since in *Amax*, tractors, graders, bulldozers, and gob haulers used in land reclamation qualified for property tax exemption as "industrial waste control facilities," this same equipment, used for identical purposes, should be exempt from sales and use taxes under IC 6-2.5-5-30 as "environmental control facilities".

Next, taxpayer asserts the predominate use test of IC 6-2.5-5-30 has been met as the bulldozers, trucks, and other property are used *exclusively* to comply with environmental mandates and standards. That is, the equipment is used to transport coarse and slurry refuse from taxpayer's mines and preparation plant to a disposal site. And later, the equipment is used to maintain the disposal site until land reclamation has been completed.

Taxpayer reminds the Department that mining operations - especially surface mining - are extensively regulated at both the state and federal levels. And while this regulatory regime addresses many concerns, the genesis of regulation is derived from the damaging environmental effects of mining operations. Taxpayer believes it would be a mistake to characterize the purpose behind waste and reclamation activities - activities conducted pursuant to state and federal regulations - as anything other than activities necessary to comply with "environmental control statutes, regulations, and standards."

The Department finds that equipment used by taxpayer to transport slurry and other coal waste to the reclamation areas, as well as equipment used to maintain reclamation areas, are entitled to the environmental control exemption.

The federal *Surface Mining Control and Reclamation Act* (30 U.S.C. § 1201 *et. seq*.) requires taxpayer to reclaim all mined land. State implementation and enforcement of these federal provisions are found at IC 14-34-1 *et. seq*. Specifically, IC 14-34-3-1 states that one may not operate a site for surface coal mining operations in Indiana "without holding a valid surface coal mining and reclamation permit." Detailed requirements for reclamation plans are described at IC 14-34-3-12. Extensive performance standards for reclamation projects - including environmental expectations - are delineated at IC 14-34-10-2.

Additionally, IC 14-36-1-1, entitled “Surface Mining Reclamation,” informs:

> Sec. 1. This chapter provides for the proper reclamation of areas of land subjected to surface mining of minerals in accordance with modern standards to do the following:
>
> (1) Provide improved land use practice of these areas.
> (2) Prevent or minimize injurious effects to the people and the natural resources of Indiana, including the need to do the following:
>
> > (A) Protect lakes and streams from pollution.
> > (B) Decrease soil erosion.
> > (C) Decrease the hazards of fire.
> > (D) Improve the aesthetic value of the landscape.
> > (E) Enhance the development of wildlife resources.
> > (F) Increase the economic contributions of the affected areas to the welfare of the people of Indiana.

For the aforementioned reasons, and in conformity with the language of IC 6-2.5-5-30, the Department finds that tangible personal property used by taxpayer for it’s waste removal and land reclamation activities qualify for exempt treatment.

FINDING

Taxpayer’s protest is sustained.

III. Sales/Use Tax — Preparation Plant Equipment

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchase of tangible personal property related to the operation of its preparation plant.

Audit determined that some of taxpayer's property used in its preparation ("prep" or "wash") plant was exempt from use tax. In justifying this exemption, Audit explained the property was used to comply with environmental control standards and regulations. (See IC 6-2.5-5-3 and 45 IAC 2.2-5-70). However, exempt status did not extend to all property used in prep plant operations. Audit excluded slurry pumps. Audit found that taxpayer used the pumps "to pump water and foreign particle residue away from the wash plant." This use, in Audit's opinion, was inconsistent with the exemption language of 45 IAC 22-5-9 as the equipment was 'not essential and integral to the mining and extraction of coal."

According to 45 IAC 2.2-5-9(4)(e), "equipment used in a coal wash plant to clean the coal prior to sale to customers" constitutes equipment that is an "essential and integral part of the integrated production process." Given this language, it was not necessary for Audit to justify an exemption for prep plant equipment under the environmental control equipment statute. However, even though Audit denied an exemption for the slurry pumps under the "essential and integral" test, an exemption could be granted if the pumps were used to meet environmental standards and regulations.

Slurry pumps are used to transport waste from taxpayer's coal prep plant to the slurry pond. As disposal of mining refuse is addressed, for environmental reasons, in the regulations governing mining activities, these pumps should qualify for exemption under IC 6-2.5-5-30 as equipment used to comply with environmental quality standards.

FINDING

Taxpayer's protest is sustained.

IV. Sales/Use Tax — Rolling Stock

DISCUSSION

Taxpayer protests the assessment of Indiana use tax on its purchase of railroad equipment, related parts, supplies, and consumables.

Taxpayer argues that its purchase of rail transportation equipment - including spare and replacement parts, rebuilding parts and accessories, components and materials, as well as associated consumables - should be exempt from Indiana gross retail tax (sales tax). In support of its position, taxpayer directs the Department's attention to the rolling stock exemption provided by IC 6-2.5-5-27.5., which states:

> Sec. 27.5. (a) For purposes of this section, "rolling stock" means rail transportation equipment, including locomotives, box cars, flatbed cars, hopper cars, tank cars, and freight cars of any type or class.

> (b) Transactions involving the following tangible personal property are exempt from the gross retail tax:
>
> (1) Rolling stock that is purchased or leased by a person.
>
> (2) All spare, replacement, and rebuilding parts or accessories, components, materials, or supplies, including lubricants and fuels, for rolling stock described in subdivision (1).

The exemptions provided by IC 6-2.5-5-27.5 became effective May 8, 1997. (See P.L.61-1997.) The assessments under protest were for the 1992, 1993, and 1994 tax years - years preceding the effective date of the exemption statute (see IC 6-2.5-5-27.5). Normally, statutes are not applied retroactively. However, in this case, the legislature indicated otherwise. Section 3 of P.L.61-1997 instructs:

> The department of state revenue shall cancel and shall no longer issue proposed assessments and assessments against a person for state gross retail or use tax on transactions described in IC 6-2.5-5-27.5, as added by this act, regardless of the tax periods involved.

FINDING

The Department finds to the extent Audit issued proposed assessments on transactions involving rolling stock, as defined in IC 6-2.5-5-27.5, taxpayer's protest is sustained.

V. Tax Administration — Negligence Penalty

DISCUSSION

Taxpayer protests the Department's imposition of the ten-percent (10%) penalty. A negligence penalty may be imposed under IC 6-8.1-10-2.1 and 45 IAC 15-11-2.

45 IAC 15-11-2 provides:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-2.1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Taxpayer contends that overall, it did make reasonable efforts in calculating and remitting tax due. Additionally, taxpayer was successful in its protest of several issues. And in areas where taxpayer did not prevail, taxpayer's interpretations of controlling authorities were reasonable.

For these reasons, the Department finds that taxpayer has shown reasonable cause and the negligence penalty should be waived.

FINDING

Taxpayer's protest of the ten-percent (10%) negligence penalty is sustained.